

Top Investor Threats

“Regulators are seeing classic threats to investors morph into new or altered dangers, many fueled by the Internet. Overarching all of these threats are unlicensed agents selling unregistered products to unsuspecting investors.”

– **NASAA President Bill Beatty**

NASAA Top Investor Threats

The following list of the top financial products and practices that threaten to trap unwary investors and small business owners was compiled by the securities regulators in NASAA's Enforcement Section.

NEW PRODUCTS, CLASSIC SCHEMES

Emerging Threats:

Binary Options: Binary options are securities in the form of options contracts that have a payout that depends on whether the underlying asset – for example, a company's stock or a stock index – increases or decreases in value. In such an all-or-nothing payout structure, investors betting on a stock price increase face two possible outcomes when the contract expires: they either receive a pre-determined amount of money if the value of the asset increased over the fixed period, or no money at all if it decreased.

Unlike a traditional option, a binary option will pay a fixed sum at expiration regardless of the magnitude of the difference between the settlement value and the option's exercise price. A call binary index option would pay out if the settlement value of the underlying index were at or above the option's exercise price at expiration, and a put binary index option would pay out if the underlying index were below the option's exercise price at expiration. The risks of binary options are: illegal distributions- trading of binary options without complying with applicable registration and distribution requirements; potential for fraud – fraudulent promotion schemes (with misleading average returns on investment); identity theft (collecting customer information such as credit card and driver's license data for unspecified uses); refusals to return, or pay out, investor funds; potential for abusive trading: manipulation of the binary options trading software to generate losing trades. Particular investor risks are that the option is an all-or-nothing payout structure and investors can easily lose their entire investment. In addition, much of the binary options market operates through Internet-based trading platforms that are not necessarily complying with applicable local regulatory requirements.

Marijuana Industry Investments: Medical marijuana is legal in 23 states and the District of Columbia, and recreational use is legal in four states and the District of Columbia. The legalization of this once prohibited substance is generating headlines and great interest across the country which, in turn, has grabbed the attention of investors looking to capitalize on the high potential of this new legal market. Many promoters have seized upon this to market and sell investments in the marijuana industry, including investments in companies that provide products and services to the marijuana industry such as vaporizers, hydroponic supplies, lighting systems, and security systems. But as is the case with any headline-generating topic, scam artists also recognize an opportunity to capitalize. Many of these companies are micro-cap companies selling low-priced securities which typically are highly speculative and carry a high degree of risk for investors. Securities regulators already are seeing “pump and dump” scams, typical of micro-cap offerings. Fraudsters lure investors with aggressive, optimistic, and potentially false and misleading information designed to create unwarranted demand for shares of a small, thinly traded company with little or no history of

financial success (the “pump”). Once share prices and volumes peak, scammers behind the ploy sell their shares at a profit, leaving investors with worthless stock (the “dump”). Investors should think carefully and do their due diligence before jumping into any marijuana-related investment.

Stream-of-Income Investments: Investors looking for monthly returns are being enticed to invest by companies that introduce investors to individuals selling a stream of income, such as pension payments or government disability payments. These investments can carry significant risks as laws may prohibit the assignment of the stream of income/benefits, the seller typically maintains the legal right to redirect the payment, and if the seller does redirect the payment, the investor may be left with an unenforceable contract right. In addition, the benefits are contingent on the life of the seller, and even life insurance policies on the seller’s life may be cancelled and do not protect an investor if a seller simply redirects the income stream. The sale of these investments also are of concern to state regulators because often veterans and disabled persons are preyed upon to assign their benefits when they experience financially stressful times, selling their much needed future benefit payments at a significant reduction. Investors should consider obtaining independent legal advice before investing in the purchase of another person’s income stream and also check with their local state regulator to confirm that the investment and those selling it are exempt from registration or are properly registered.

Digital Currency and Cybersecurity: Digital currencies are emerging as trendy way of paying for goods and services. Bitcoin, perhaps the most popular digital currency, was priced at around \$10 per unit in early 2013 but peaked at around \$1200 per unit later that year. The rapid increase in price sparked considerable public interest and significant media attention, creating a fresh market for securities offerings tied to digital currencies. Unfortunately, unscrupulous promoters may be attempting to capitalize on this popularity by illegally offering securities tied to digital currencies. Even legitimate securities offerings tied to digital currencies may present considerable risks to the investing public, including risks associated with volatility and demand for the units, the anonymity associated with the use of certain digital currencies, and the threats posed by hackers using malicious software to compromise network security systems. The risks associated with cybersecurity were highlighted earlier this year when Mt. Gox, once the world’s largest Bitcoin exchange, filed for bankruptcy amid reports that hackers may have stolen around 850,000 bitcoins worth as much as \$500 million.

Persistent Threats:

Pyramid and other Ponzi Schemes: One of the most disturbing trends in reality was the rise in multilevel marketing offerings that were pyramid schemes (MLM). These MLM schemes are a combination of a Ponzi scheme perpetrated in an affinity fraud fueled by the Internet. Some common characteristics are: the product is ancillary to the overall scheme; money is made primarily when you recruit others to purchase the investment, not from actual product sales; these fraudulent MLMs pay earlier investors with funds from later investors; and specific payouts are often guaranteed by promoters. These multi-level marketing frauds usually involve affinity fraud and can be spread quickly through word-of-mouth, the Internet and social media. The most recent investigations of these frauds involved Spanish, Portuguese, Brazilian and Asian-American communities, but anyone is potentially vulnerable. They can expand rapidly via the Internet ensnaring more unsuspecting victims. Individuals behind these scams seem to morph from one fraudulent scheme to the next as regulators and law enforcement close in. They are multijurisdictional and in many cases global thereby creating a multitude of issues for individuals seeking recovery and regulators protecting investors.

Regulation D, Rule 506: Private Placement Offerings often referred to as “Reg D” or “Rule 506” offerings are among the most cited examples of fraudulent securities. These generally highly illiquid and rather opaque securities have little oversight. These securities are federally regulated, and no filings are required with either the SEC or states until after sales are made to investors. Even then, state securities regulators have little authority over these transactions

unless fraud is discovered. Private Placement Offerings, ostensibly sold only to accredited investors, continue as one of the top threats to investors. With the federal JOBS Act amendments that now allow general solicitation and advertising of these private placements prior to any filings with federal or state regulators, it is more difficult than ever for investors, and regulators, to ferret out abuses in advance of sales. While there are a number of legitimate firms offering private placement securities, investors must be wary and vigilant before investing.

Risky Oil and Gas Drilling Programs: Investors should be wary of believing that recent headlines of the current oil and gas boom are indications of potential high returns in oil and gas drilling programs. Hydraulic fracturing, also known as “fracking,” and horizontal drilling are credited with facilitating record levels of oil and natural gas production in this new, technology-driven boom that has grabbed national headlines. Unfortunately, scam artists and unscrupulous promoters follow the headlines and are quick to capitalize on the increased interest of investors who are frequently unfamiliar with the high degree of risk typically associated with oil and gas ventures. These types of energy investments are generally only suitable for investors who can bear the loss of their entire principal. Some promoters will conceal these risks by using high pressure sales tactics and deceptive marketing practices to peddle worthless investments in oil wells to the investing public. Consequently, regulators expect to see an increase in enforcement actions from previous years. Investors should conduct thorough due diligence and assess their own tolerance for considerable risk when contemplating the purchase of interests in oil and gas programs.

Internet and Affinity Fraud: How an investor learns of a product does not always insure credibility. As set forth above, many of the threats involve frauds perpetuated through the Internet and through relationships that may give an investor a feeling that an investment must be safe. Investors are encouraged to not assume the legitimacy of an investment simply because it is presented with an Internet website, or through a trusted acquaintance. State regulators can easily confirm that an investment is registered, or a sales person is properly licensed before you invest

Real Estate Schemes Including Those Utilizing Promissory Notes: As the real estate market continues to recover, and traditional methods of earning interest remain low, state regulators continue to see fraud in Real Estate Schemes and Promissory Notes. These schemes were the second most frequently reported problem areas in the 2013 data. Investors are encouraged to perform due diligence on these alternative investments, and consider requesting information regarding the source of repayment, real estate appraisals, title reports, company financials and other important information. Typically an investment that promises a return several times higher than interest rates available from a traditional institution carries with it a much higher risk.